Francesco Filia: Plotting a Course for Digitization of Financial Markets

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Erik: Joining me now is Francesco Filia, founder of Fasanara Capital. Francesco has prepared a terrific slide deck for today's interview. Registered users will find the download link in your research roundup email. If you don't have a research roundup email, it means you're not yet registered at macrovoices.com. Just go to our homepage, macrovoices.com, click on the red button that says looking for the downloads.

Francesco, it's great to have you back on the show. It's been way too long, you know, something I've been thinking a lot about in the last year is DeFi, decentralized finance. It's going to completely totally change everything. And frankly, I think most people in the industry don't understand that yet. But exactly what form it's going to take. Who's going to be in charge and how we're going to sort out this intersection between new technology and an industry that's slow to change is going to be really interesting to watch. You've got a whole slide deck that talks about first the existing conditions in the economy and leads into where we're headed with DeFi. So I'm really excited about this one. Let's go ahead and dive into it.

Francesco: Thank you, Erik and thank you for the invite. It is a pleasure to be here and happy to start with the current situation in markets. And obviously here it's a little bit of a broken record from myself when it's about the expensiveness of both bonds and equities at the same time. And we've been researching this for several years now. We have spotted the conditions of a bubble, bubble financial markets in both bonds and equities for you know, several years now. And definitely we have been wrong in predicting the direction of travel because markets kept rising over this period. But still, you know, like our main point of contention is that evaluations make no sense. And it is becoming ultra hard for institutional investors, which apply rational investing to be involved with the public bonds and equities at current levels of valuations. And, you know, one word on bonds and one word on equities. Bonds since 2016 has been trading at close to zero interest rates if not deeply negative, and they've stopped, you know, functioning effectively. And our idea is that, as an asset class, it has been retired, and it may be considered the fund, you know, it has stopped to be sensitive to levels of inflations and level of economic activities since several years now.

And it's funny that we lament that rates may be rising at this point in time in the markets, when we are still talking about negative rates in most western market economies. Even in the US, we're talking about a 10-year rate at 1.5% and the 30 year rate below 2%. And if you ask me, these levels are very close to zero, and they are closer to zero than anywhere else. And then you know, the problem with this is that, you know bonds, they have a function within portfolios, which is to counterbalance the allocation to equities to save the day at times in which the equity have a very bad day. And they can no longer fulfill that function because they're just no longer there. A bond is a coupon bearing instrument, whose coupon are currently zero, and therefore is a zero coupon bond. But typically, a zero coupon bond is one that you buy below par, and you enjoy the pull to par. In this case, you buy it at par or sometimes above par. So you're looking at a bond that within your portfolio and within your wallet. But effectively, there is no bond there, what you're looking at is a quasi cash or quasi bond, but it's definitely a new instrument that you're not accustomed to. And there is nothing there.

So within all those balanced portfolios, where we have a 40 to 60% allocation to bonds then we can claim that the 40 to 60% of allocation really does not exist. Now there is a and we may claim that there is no reversion to mean either. Now there is a lot of talk about inflation, right. And inflation has been printing out very widely lately to 6% and over 6%. And obviously there is the fear of rising interest rates. But the problem that we're facing is that if our theory is correct, bonds will not react to that. And the rates will not move higher in any meaningful fashion. If it is true that the bond as an instrument has been retired and no longer fulfill the function of what it used to be. And obviously I'm making a big statement, I'm exaggerating, you know, to exaggerate the argument to make it visible. But basically my idea is that the so called the Lazarus trader, the trader mean reversion where rates go back higher may not be seen anytime soon, as a reflection of the fact that the linkage between bonds as an asset class and fundamentals is broken in a very fundamental way. And this is a problem. This is a problem because you cannot rely on bonds anymore for asset allocation.

And then obviously equities right, so a word on equities. Equities are also very expensive as known to most people after the pandemic, they went into more extravagant levels. We have seen the technology equity complex reaching 10 trillion in market valuation alone. If you include just FAANG stocks, and the like we have seen indices this year, rallying to new highs. The NASDAQ is 20% up over 20% year to date. But actually, when you take out the top five stocks within the NASDAQ, it's actually down 20%. So what you see is not only extreme valuations, but also extreme concentration. And so like, and there are multiple ratios, and I don't want to go into multiple ratios here during the call, but basically, like there are multiple data points that they showed that the market is as expensive as it has ever been compared to GDP, for example, i tis twice as expensive as during dotcom bubble. Obviously, if you're an institutional locator, it's very hard to cope with a market like this and not be in fear of fast and violent drawdowns.

And so like, you know, my point is that the job of an allocator looking at traditional asset classes like equity and bonds has become extremely difficult to navigate these markets from now on. And to be able to, you know, to have faith in markets at these levels. You have bonds that they cannot save the day, equities goes down, you have equities that are ultra expensive and the risk of a drawdown is extreme and you are left a little bit between a rock and a hard place. Now after this big rally in levels, we are facing a January 2022 which may be like I'm not trying to predict here a big crash. I think that there is something more interesting to do in the current market than just predicting the next three months. But if we look at the next three months is that there is a possibility that the January 2022 looks a little bit like one of the previous January's that we've been through. January 2000, January 2008, January 2018 and January 2020. And we know of those January's that they proceeded faster, faster drawdown so dotcom was followed by the dotcom implosion and the 2008 is obviously linked to the Lehman moment. 2018 saw a faster down especially on the February VIX complex implosion, and obviously January 2020 was then followed by a very heavy March following the lockdown as a response to the pandemic.

And now again, we may be seeing a blow off top followed by some sort of a drawdown. But in the trigger tweet, it's not even that relevant. It could be interest rates following inflation, I don't think so. Or it could be something else like a market falling under its own weight. But we already know what is the reaction function of policy makers. And we already know that if there is a fallout in prices, it would be followed by an even more forceful monetary printing and market intervention. And it's probably going to be recouped. And the probably another buy the dip is going to show up and the market is going to pick up from those levels. What we have learned over the past over 10 years is that markets have lost their function of allocating to the real economy, because they've completely been confined into a space in which they are self referencing. So whenever there is some fallout, there is an immediate intervention by policymakers and the market has been unable to develop the anti corpse against those fallout to recover on its own merit.

And then there is one slide in this big deck that is on page 11 that tries to draw the linkage between these different market phases and the real DNA of the market as we see it. And it goes from depicting actually like I think that the big disease in the market is a one of short termism and it can be seen in the markets but also in societies at large. And the way I look at it is that, you know, the full lockdown after the pandemic, but also quantitative easing, also talks of modern monetary theory and even populism. They're kind of symptoms of the same underlying theme and the theme is a short termism. It's basically an attitude to swap, you know, short term solutions for long term problems is an attitude of not being able to endure like duress in markets, as much as in society. And therefore to always look for the easy solution that is able to trigger the positive very short term effect, but always at the expenses of a longer term, a bigger problem.

These fundamental disease and these fundamental medical condition, let's say of the markets but those of society at large has led into an investment community which has been, which has gone through a *retailification*, I call it so everybody's playing as a retail. Both retail and institutional investors trying to survive to some extent or fund management. And so like in retail, we know the new generation of Robinhood to the new generation of reddit has driven investment investments, which is kind of less driven by fundamentals and more by momentum and by emotions to some extent as well. But you know, what is more interesting to analyze is the institutional side of things. The institutionalized asset management world, which in an in an attempt to survive, as endorsed some of the attributes and attitudes of the retail community and therefore has been going from being an Hedge Fund and investing into long only, even when you are a long short equity of a very big beta correlation and a very big net exposure. And you know, very few are really shorting stocks these days in any successful fashion at least. And then, you know, in the buy, the dip mentality has completely spread around and is affecting most market participants.

Following this retailification, you have the Bitcoinization of markets. And what I mean by that is basically, in a place where public markets have become video gaming, and where effectively like there is no reference to the real economy anymore. The reference to the real economy and to fundamentals is lost. And as a consequence of that the main function of markets has been lost as well, which is allocating resources to the real economy to support both consumers and corporations. And this is reflected also in the current levels of interest rates and in the current level of equities.

The good story is that there is an emerging trend which substitutes these, let's say, all asset classes, and that at least tries to produce an alternative to them, although not in total, not in full, but for some partial in some partial ways. And that the alternative is, you know, ways to access the real economy in a most in a more decentralized fashion. And I'm not talking only about decentralized finance in the ways of cryptocurrencies and blockchain. I'm also talking about platforms and the platform economy, the so called the India utilize another audible term, which is a *platformification* of credit, and the economy. And this represents, in my personal opinion, the new capital markets, that they can offer an alternative to institutional investors, but also to, in general, to market participants. And when I talk about platforms, I mean, FinTech, the FinTech trend, in all these new ways to reach out to the real economy to originate loans and receivables to both consumers and corporations. And that they can form an alternative to bonds at a time in which bonds have disappeared and they are trading at zero.

Erik: Okay, so you think that bonds are going to be replaced by new credit instruments that are going to be decentralized, finance driven based on some type of secure digital bearer asset.

Francesco: Substituted is a very big term, right, because you're talking about the largest asset class out there. But I think that we have seen in the last few years, the emergence of these new properties of this system in transition, and we've gone past the critical threshold of a point of no return. So these are tip of the iceberg has been emerging. And the rest of the iceberg will emerge in the course of the following several years. And whether or not is a full substitution, or is just like getting in parallel to the bond markets. Obviously, it's more likely to be in parallel to the bond markets, nothing is going to be really extinguished in full. But definitely we are going to see this trend emerging more and more, we're going to see more and more platform substituting banks, for example, and the cutting of the middle man being you know, the bank, the bank intermediation more and more in more fundamental ways and reaching out directly to the real economy, to provide the real economy with what now the real economy is not capable of receiving from public bonds, for example.

Now, I'm not talking about the large corporates, right. The large corporate is always have access to the market, and probably the close to 0% funding costs is justified for them. I'm talking about the middle market, which is also the big one out there. Midsize corporates, and those who, like consumers less rich, don't have an easy access to funding. And there is a dramatic need on the side of the real economy for funding that the market is no longer able to fulfill by a market but also like banks, to some extent, you know, the funding gap just in Europe, it's been estimated that over 1.5 trillion euros so we're not talking about a niche in the market. We are talking about the big market out there. We're talking about the real economy.

Erik: Francesco let's talk about how this plays out because some people would say okay, the biggest financial institutions have figured out that DeFi is a big thing. And you're going to see JP Morgan and other big institutions leading this charge. Other people would say those are big behemoths are just so out of touch. They're lost what you're going to see, is the finance industry being taken over by new companies whose names we've never heard of before. Which is it? Or is it something in between? How does this all play out? And how do we get through? You know, I think of this kind of being analogous to dotcom experience in the late 90s. Everybody suddenly figured out the internet was going to be a big deal. And they were right about that. But they responded by just buying everything with dotcom in its name without thinking first. And it seems like we're kind of at the same stage. What's the next step? How do we get to thinking?

Francesco: Look they are varying aspect like to that right? So let's look at the one regarding banks, right, the banks, most of the commercial banks out there have been a completely, you know standing still in the middle of the road, right, and then not being able to react. So if you look at the reaction function in the last few years, in which the FinTech trend has been emerging and very visibly, before everybody's eyes, they have not tried much to counteract it in any meaningful fashion. So actually, the competitive landscape to this new fintechs has been quite an easy one, because there was not as much of a pushback from the incumbents. And there are a few exceptions to the rule. Of course, there are some banks which have played a very strong game. And they can also name a few like a Goldman, JP Morgan, Santander, Standard Chartered. They're very visible on the field, and they're very present, etc. But let me talk about everything else, right, everything else has been really lacking, like aggressiveness in tackling these emerging trend. And there are a couple of reasons.

One is that or perhaps three one is that the for how much we want to lament the bank's profitability, but still, they make a lot of money. They still can get their money at the sub zero interest rates from the central banks. And perhaps they don't need to do much to keep being rich. Right? You know, the second reason is that is extremely difficult to do an IT upgrade if you are a bank, you know, you have too much legacy infrastructure, and it's very difficult to detach yourself from it to create something new. The third reason is regulation. That is, you know, there is always obviously, a random forest of regulation is very difficult to disentangle, and go follow in the footsteps of unregulated fintechs. If you read the annual letter of Jamie Dimon, you know, you will see like, how real the FinTech trend is in our vocally, he's about, you know, lamenting, for example, the lack of a level playing field against these FinTech and some of like some of his statements out of the annual letter to investors. Our banks are playing in an increasingly smaller role in the financial system. You know, the growth in the shadows in FinTech banking calls for level playing field regulation. Institutional Investors are left without bonds, they need to look at alternatives. The banks are retrenching and therefore, this gap to be filled that can be filled by institutional investors.

Erik: Okay, Francesco. So we're talking about a scenario where small FinTech companies could start displacing big finance companies by offering basically new tricks new and better ways of doing things. Sounds to me like a setup for a major wave of acquisitions of those FinTech companies. But we still have this problem that the way we got to this conversation was institutional investors not really having a good replacement for bonds. So what's the answer to that question?

Francesco: The answer to that question is that the, you know, luckily, enough, institutional investors can decide to partially leave the gambling environment in public markets, like especially bonds are trading at zero rates and involve themselves or more closely with the real economy through the FinTech channels, bypassing perhaps also, you know, banks in their role of, you know, like syndicating bonds and stuff, and helping directly the real economy where it matters the most. So in the middle market with small and medium enterprises, let's just see what's happening. On the one end, the banks are retrenching from the SME market due to regulation, due to the lack of technology needed to serve the middle market. And they are concentrating on mainstream markets, which means that they're very large corporates around the globe. And this is happening across not just in Europe, also in the US, even in Asia. As banks withdraw funding, institutional investors can step in their shoes, and fulfill also the law or the role of allocating to the real economy and at the same time, and they can also help themselves by substituting some of those bonds, yielding nothing with the properly yielding securities generated directly from the real economy through these new technologies, including FinTech, but also then eventually, at some point down the road not now but in a few years also decentralized finance when the right time comes also to include the cryptocurrencies in this argument.

Erik: Okay, Francesco, but when you talk about including cryptocurrencies in the argument if we start with bonds. Bonds were a promise by somebody to repay real money to someone somewhere. Cryptocurrency is a token which similar to gold, its value is basically its uniqueness or its rareness. And there's a lot of debate about that. So does it really make sense for institutions to be replacing bonds, which are a promise for somebody to pay money with an investment in a token, which maybe has strategic value, depending?

Francesco: And the quick answer is no, not today, for sure. I believe that the cryptocurrencies market is a is a is not ready for institutional adoption, not as yet. I mean, we've seen multiple cases in the last couple of years of what looks like the start of an adoption trend, but definitely it will take longer and definitely regulation is needed before institutional companies can properly look at allocating into cryptocurrencies. I think what you're seeing now, though, is a definite adoption of a FinTech, in the meantime, by institutional investors in an attempt to substitute bonds with some alternative yielding securities, which are offered through by FinTech. The way I look at it is that you have the the old economy, which is the capital markets, as we know them bonds and equities. Then you have the FinTech economy, which is effectively financial markets 2.0. And then you have the cryptocurrencies and the decentralized finance and everything else, which is effectively financial markets 4.0. So we are on this timeline, I think the future belongs to a combination of the three. So nothing is being extinguished. It's just being joined by new things and the new technologies. And at some point in the future, we are looking at a multiverse where a few things, a few elements are coexisting there will be bonds and equities, there will be FinTech originated bonds and equities. And it would be also like a cryptocurrencies generated the new securities.

Erik: Moving on to slide 14, I see that you're starting to talk about a digital future that includes digital lending, which I've for many years said is an absolutely essential part of this. How do you see that playing out?

Francesco: What digital lending is exactly this right? So it's basically when so digital lending the way we classify it here you see that we compare it with digital assets, right, so digital assets is cryptocurrencies, decentralized finance, NFT. And community owned economies like this new trend of decentralization, disintermediation. Digital lending, the way we define it is a FinTech lending. So is the lending happening outside of the traditional banking channels, and it rhymes with embedded finance in platform economies? Right. So it is this way of running a bankless access to the real economy, and producing loans and receivables financing for especially SMEs, but also consumers all across the globe. You have seen this trend emerging already 10 years ago in the US a little bit shorter, seven years ago, around seven years ago in Europe, and that this trend is already into the multi billion. And we expect this to move into the 10s of billions in the next five years leading into the market economy of 2025.

Erik: Francesco, you've outlined a vision for how you see this unfolding. Tell us a little more about it.

Francesco: Yeah, so the vision is one in which basically, this there is this big reshuffle, right? Across investors and across also the real economy and the asset classes. Right. And I think that division is that the asset management community should really be looking at transforming itself away from traditional asset classes and traditional description of investment strategies, and try to be designing themselves for the future and to try to build portfolios, which are future proof, right? Nowadays, you've seen that the successful strategies are a little bit of a hybrid, and a little bit more niche. And a little bit more crossover than in the past. So for example, in the private equity industry, and in the venture capital industry, you see funds like Tiger global, like really, you know, hitting the road running by being crossover, right. So instead of it being allocated either to public or private assets, they do both. And they include the velocity into their modus operandi. And this is something completely new that is taking the oil industry by storm. In other trans strategy, you see multi strat unconstrained funds that are able to perform better because they can transfer it delays across multiple managers, and they increase their degrees of freedom when it's about dealing with the market. And so we envision a world in which there is going to be more and more commingling between different things. And definitely we also see a world in which more assets are investable. And, you know, like, for example, like from the sneakers to watches to trading cards, you know, everything will become a tradable asset and an investable assets. And in this case, obviously the blockchain that comes to help because everything can be linked to a unique identifier, right. And so as a consequence of that, can then be traded.

And then we see a market in which, you know, you need to keep yourself if you're an asset manager with a lot more technology than you're used to. You know, the old model was that you could, as a hedge fund manager, 5 billion with five people, and do a good job at that by calling a macro turning events, I think that that world is a bit lost. And now, to make a proper job, and to do a sustainable performance over the years, you need to go much deeper, make a much more profound homework. You need to equip yourself with the right technology. And you know, you need to become a technologist, effectively. And there is a lot more work required, for example, in what we have experienced off in connecting to the real economy, in being able to channel these funds to the real economy to both consumers and the corporations. And that takes much longer, right, but it's more sustainable, and is more future proof is more looking beyond the next few years. And, you know, like, to what the market may look like 10 years from now. And I think that, you know, the problem with the asset management industry these days is that it's the same problem that you have, when you compare, you know, you know, experience with the experimentation. You know, a lot of the market players these days have got a lot of experience, but because of these experiences, they don't experiment. They look at experimentation as a, you know, like something like a waste of time. I think that that is the problem, because the market is changing in very fundamental ways. The market is going through a very deep transformation, a critical transformation and experimentation is really key.

If you stop experimenting in times like this, you expose yourself to, you know, to the changing times, and you're probably going to be outdated very soon, faster than is expected. This is also linked to the age of the investment community, right? You know, the, it's no surprise that the millennials and generations that represent more and more, they have more and more of a role in the current market is absolutely no surprise. They are able to experiment much more than old guys that they think they know. And they think they don't need to experiment anymore. It's also the dichotomy between, you know, exploitation and you know, exploration. Exploitation is when my business is working very well, and I don't need to explore. And that is the problem with banks, and the incumbents. That is the problem with largest managers, they're making too much money, they're too rich to really have to explore. But again, if you don't exploring these, like these, you run the risk of being outdated, and being ruled out by markets in transforming markets in only, you know, a handful of years.

Erik: Okay, Francesco. So it sounds like the big picture here is you're expecting a digitization of the financial industry to occur over a period of years where nobody's really in charge. It's just incremental. And you know, new ideas come along, and somebody likes it, and it takes off. Is that the gist of it? And what does this mean for you know, we have a lot of institutional investors in the audience. What does this mean if the whole world is going to change over the next 20 years, but it's not really clear how it's going to change? I mean, just knowing that high level outline of where we're headed would be so helpful, but of course, it's unknowable.

Francesco: It is unknowable. I mean, I think that institutional investors have got a chance, which is to embrace the novelty in markets, which is offered by new technologies in more and more like generous ways. Obviously, like it's very difficult for institutional investors that are heavily regulated, to embrace the new, but, you know, a point comes in time when that is unavoidable and no longer like a delayable and they think that point is a scam in recent times. And I think that you know, more and more like these new trends would be visible in performance right? You know, in performance when it comes down to asset managers, you know, what matters is really the performance in the like, if you are linked and limited by the older classifiers in the asset management industry, to be either long short equity or relatively fixed income or like, you know, long only equity or like all the other ones. I mean, chances are that, you know, you will be unable to compete against the more flexible players in the market, which are future proof, and they will keep themselves with the right technology, they will keep themselves with the right scope of activities.

We are seeing more and more of this in the market. I think we are going to see these trend emerging very robustly, and institutional investors I think, ultimately will have to adapt to this changing environment and then we level some more options, right and the good part of it that I see is that in this transformation, who benefits is really the middlemen in the middle corporate, which are left behind by the traditional markets and have been left behind for such a long time. So actually, this is a very positive trend. It is a trend of decentralization, disintermediation, dematerialization as well, but it's a trend that ultimately speaks the language of financial inclusion and is very much in tune with times.

Erik: Well Francesco, I can't thank you enough for a terrific interview. But before I let you go, please tell us a little bit more about what you do at Fasanara Capital.

Francesco: Fasanara is an asset management and technology company and technology platform. We've been around 10 years. We manage our strategies in both digital lending and digital assets and quantitative strategies of trading. So digital lending means a FinTech and fintech technology to reach out to the real economy. Digital assets means cryptocurrencies arbitrage funds. We have you know, basically like we are trying to monetize inefficiency, the volatility of these asset class in cryptocurrencies, and we try basically to build portfolios, which are future proof. And so allow institutional investors which is the vast majority of our assets under management to access the real economy utilizing these new technologies, in ways in which they can be defended from the twin bubbles in public markets, and the ways in which they can find alternatives to the traditional bonds and equities.

Erik: Patrick Ceresna and I will be back as MacroVoices continues right after this message from our sponsor.